

ECONOMICS FOCUS

Lender without limit

Should the IMF be bigger or smaller—or somewhere in between?

LAST week's Economics focus compared corporate bankruptcy with national bankruptcy. When firms go bust, it explained, a kind of market failure stops creditors acting in their best interests. This justifies bankruptcy rules imposed from above. Similar arguments can apply to countries. Hence the case for arrangements that, albeit loosely, apply aspects of the corporate-bankruptcy model to troubled national borrowers—measures such as “stays” on debt service, sharing clauses in bond contracts, and so forth.

Quite another approach is sometimes suggested: to create an international “lender of last resort”. The analogy is different, with cash-strapped governments likened not to companies in trouble but to distressed banks; however, the underlying market failure is the same. And at first sight the idea seems promising. After all, the IMF resembles a lender of last resort more than it does a bankruptcy court.

The trouble is, the term “lender of last resort” is used loosely these days. Classically, a lender of last resort lends (a) freely, (b) to banks that are distressed but solvent, (c) against collateral and (d) at a penal rate of interest. It lets insolvent banks fail; it helps only sound banks facing a temporary lack of liquidity. This mitigates the moral hazard implicit in bank rescues; so do (c) and (d).

Could the IMF do the same for distressed governments? Jeffrey Sachs, who first applied the bankruptcy model to countries, argues that the Mexican rescue of 1995 did in fact have these classical features. The rescue was big; the economy was “solvent”; oil revenues served as collateral; the loans were short-term and appropriately priced. But as Mr Sachs emphasises, the chief lender in this case was not the IMF but the United States government. Why? Because Mexico needed \$50 billion, far more than the IMF could lend.

An IMF equipped to supply Mexico-style packages on demand would have to be vastly larger than it is now. This is politically impractical: America can hardly bring itself to pay for the Fund at its present size. But a luxuriously endowed IMF would also be bad economics. It would create a correspondingly awesome moral hazard. The rules of solvency, collateral and penal interest rates may have held in Mexico's case, but they could never bear the strain of an agency with lots of ready cash, keen to justify its existence. A flush IMF could not look on as, say, South Korea, for lack of collateral, went to the wall.

Tomorrow the world

Perhaps a mega-IMF could cope with moral hazard in some other way, by acting as a before-the-fact supervisor of policy, not an after-the-fact one? In a modest fashion, the new facility proposed by the United States at this week's meetings in Washington seems to call for this. Countries would have to qualify in advance for access to the money—rather than, as now, having to satisfy the Fund's demands for changes in policy only after mistakes had been made and the damage done.

A facility of this kind might be useful, but it cannot be the basis for a vastly bigger IMF. Again, that is politically out of the question: aside from the cost, giving the Fund the much enlarged role that adequate before-the-fact supervision would imply is not on. As before, even if those obstacles could be overcome, the idea is flawed in principle. However good the supervision, it is doubtful that the moral-hazard problems created by an IMF with lots of cash could be adequately contained. In a world of extreme mobility of capital, finding ways to channel private money where it is needed seems more promising than any plans for huge countervailing flows of public money.

It seems, therefore, better to build on the first approach: developing bankruptcy-like arrangements that would supplement IMF lending with larger and earlier private-sector participation. But that still leaves one other question. If the IMF cannot (and should not) be big enough to act as a proper lender of last resort, should it lend at all? The *Financial Times* argued recently that it was logical, though futile, to call for a mega-IMF, but that an IMF deploying anything like its present puny resources does more harm than good. “creates the illusion of protection, which only makes the world more dangerous.” The conclusion, presumably, is that the IMF should stop lending altogether.

This is wrong. Plainly a balance must be struck between coping with the emergencies that come along (which argues for more IMF lending) and discouraging emergencies from happening in the first place (which argues for less). The least unsatisfactory answer is to be found in the muddled middle: not all that far, in fact, from where the system is today. If there were no official lending at all, there might be fewer crises, but there would still be some—and some of those might be terribly severe. (The recessions in Asia are bad as it is; imagine how much worse they would have been without the Fund's big injections of resources.) It is simply not credible to suppose that governments could stand aside. The cliché is true: if the IMF (and its loans) did not exist, governments would now be trying to invent it.

The mistake is to think that the moral-hazard dilemma can be eliminated, either with vastly greater IMF lending-plus-supervision, or with no IMF lending at all. The dilemma cannot be eliminated. The real task is to improve the compromise. A mixture of better-designed IMF lending, new bankruptcy-like procedures (to increase the burden on private creditors) and an occasional salutary sense of crisis is not merely the likeliest design for the world's new financial “architecture”, given the political facts; for the foreseeable future it is the wisest design too.

“The East Asian Financial Crisis” by Jeffrey Sachs and Steven Radelet shows the bankruptcy model in action (it can be downloaded from www.hiidd.harvard.edu). A more detailed study of the bankruptcy analogy is in “Crisis? What Crisis? Orderly Work-Outs for Sovereign Debtors” by Barry Eichengreen and Richard Portes (CEPR, 1995). The article in the *Financial Times* almost but not quite arguing for the IMF's lending to be stopped was by Martin Wolf and appeared in the issue of September 23rd (www.ft.com).

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